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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

POSTAL RATE AND FEE CHANGES	Docket No. R97-1

BRIEF OF THE AMERICAN POSTAL WORKERS UNION, AFL-CIO

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The American Postal Workers Union, AFL-CIO ("APWU"), hereby submits its brief to the Postal Rate Commission ("PRC") concerning the request by the United States Postal Service ("USPS") for the PRC to submit to the Governors of the Postal Service a recommended decision. This brief argues that the Commission should

- accept the USPS's test year estimates and implement the requested rate increase in a timely fashion;
- reject arguments to increase rates even further in mail classes where business has been growing the fastest, and in particular Standard B parcels;
- use Ramsey pricing as a starting point to set rates but cost avoided to set discounts;
- implement the prepaid reply mail rate category requested by the USPS; and
- accept the conclusion of USPS Witness Bradley's testimony that labor related mail processing costs vary by less than volume.

I. THE COMMISSION SHOULD ACCEPT THE TEST YEAR ESTIMATES AND IMPLEMENT THE RATE INCREASE REQUESTED BY THE USPS

In general, the APWU supports the test year figures provided by the Postal Service and the rate increase and discounts requested by the USPS. The APWU supports the rates proposed by the USPS because they are close to rates that emerge from Ramsey pricing. (See below, Section III.)

Even with the new rates requested by the Postal Service, first class stamp price increases continue to lag behind general inflation as represented by the Consumer Price Index. This lagged has occurred while Congress imposed numerous additional costs on the USPS and failed to allocate sufficient funds needed for subsidized mail categories. The ability of the Postal Service to keep rate increases below inflation is due in part to the increasing productivity of the Postal Service's labor force.

Despite rate increases below inflation, some intervenors argue that the rate increase is unnecessary. These intervenors seem to argue that if the USPS recalculates its 1998 test year figures, using data which became available after the rate case was filed, the resulting revenue requirement will fall below anticipated test year revenues, thus negating any need for a rate increase.

Mr. Porras in his rebuttal testimony (USPS-RT-11) makes a cogent argument that the established procedure is not to factor new data into an ongoing rate case. He points out (at 19) that in R90-1, the negative effects of 1990 OBRA were not factored into the rate case even though they became known while the rate case was proceeding. According to Porras, the USPS decided the appropriate course was "... to live with the rates and revenue requirements it had requested even though they were now considered to be deficient as a result of the OBRA of 1990."

The Commission should not accept the intervenors arguments. The data should not be modified to use figures which were available only after the filing of the case. The Commission should not establish a precedent of redoing the figures in an on-going rate case. As was the situation in R90-1, in future rate cases the new data may not support lowering the rate request, but may suggest increasing it mid-case. The Commission should adopt a neutral policy. It should avoid factoring in new data whether the new data would lead to an increase or a decrease in the rates.

An even more serious issue of due process could arise by continually updating data. If the USPS were to continue to update revenues and revenue requirements during a rate case a great deal of uncertainty would be introduced into each rate case. No one, not the Commission, not the Postal Service and not the intervenors would know what the revenues and revenue requirements would be before the test year. In addition, there would be endless discussions on the validity of new figures and new data each time the USPS updated the data. For the Postal Service, Mr. Porras has argued (at 10) that updating the data and models "... would require a significant amount of re-programming and manual intervention ... The time required to identify and calculate the required adjustments ...would be substantial." With continuous updating of the data, it would be impossible to complete a rate case in the ten months normally allotted to it. Additionally, there is the time and expense for all concerned in having to reexamine the data with every update and in extending the rate case beyond the normal ten month period. All in all, it would appear to be preferable for the Commission to accept the Postal Service's test year figures as submitted at the time of filing as the basis for the proposed rates.

Besides the issue of factoring in new data, there is the secondary issue of the size of rate increases. In the past, rate increases have occurred in rather large increments relative to the then existing rates. By contrast the rate increase proposed in this rate case is rather modest, especially in first class mail. Failure to recommend an increase now will probably mean a new rate case later this year, especially if Mr. Porras is correct in saying (at 15) " ... that approved FY 1998 program expenses will be incurred" as expected, and that furthermore (at 21) " ... the revenue requirement underlying the current filing remains reasonable and does not require adjustment." If a new rate case is filed, then the USPS would no doubt request a larger increase in rates than was requested in the current rate case. It would seem preferable for all concerned that rate increases be smaller and steadier than larger and less frequent. Consequently, the Commission should recommend, in a timely fashion, the rate increases requested by the Postal Service in this Docket.

II. SOME OF THE HIGHEST RATE INCREASES ARE IN THE FASTEST GROWING AND MOST COMPETITIVE CLASSES: THE COMMISSION SHOULD REJECT ARGUMENTS BY CERTAIN INTERVENORS TO INCREASE RATES EVEN FURTHER IN THOSE CLASSES

Relatively speaking, the USPS has requested fairly substantial rate increases in certain classes of mail. Most notably it has requested a fairly large increase in one of the most competitive classes, Standard B parcels. The APWU is concerned that some of the largest rate increases have been proposed for the fastest growing and most competitive areas of business. In general, it would appear to make better business sense to have more modest rate increases in rapidly growing areas of business, especially those facing substantial competition. Certain intervenors, however, most notably United Parcel Service ("UPS"), are not satisfied with the rate increase requested for Standard B parcels by the Postal Service. UPS has argued for an even larger rate increase.

The argument the UPS has put forward for Standard B is that the cost coverage is too small. It argues that the cost coverage and the rates for Standard B should be higher. The flaw in the UPS argument is that the cost data on which the argument is based are quite poor. In particular, the costs of Standard B parcels appear to be over-estimated. There are at least two sources for the over-estimation. One is the presence of excess capacity in the transportation of zoned parcel rates, which was identified in the testimony of Florida Gift Fruit Shippers Association Witness Ball (in FGFSA-T-2, at 13). The other source of over-estimation is the excess of Alaska air transportation costs over surface transportation costs. This excess, which was included in the costs by the Postal Service when it should not have been, was pointed out by Parcel Shippers' Association Witness Jellison (PSA-T-1), based on the Commission's own O & R in R94-1 (at III-53, para. 3174 ff.). In R94-1 the Commission mandated that the excess costs of serving Alaska should be considered part of the Postal Service's universal service obligation and did not include the excess exclusively in zoned parcel post costs. Instead, the Commission included these excess costs in the institutional costs that are spread over all classes of mail.

The APWU's position is that Standard B rates should be the ones proposed by the Postal Service, because of considerations based on Ramsey pricing which are discussed below in Section III. Using Ramsey pricing would have generated higher rates in Standard B than those requested by the USPS; but the two sources of error just outlined for Standard B serve to offset the Ramsey requirements for higher prices. For this reason, the APWU concludes that the Postal Service's requested rates are the ones that should be implemented as they are closest to the rates that would be produced by Ramsey pricing without these two errors.

III. RAMSEY PRICING

In this rate case the USPS presented testimony about how Ramsey pricing can be used to determine rates. (See USPS T-31.) The Postal Service, however, did not use Ramsey pricing to determine the proposed rates (USPS T-30, at 21). It would appear that the purpose of the testimony about Ramsey pricing was to set the stage to use such pricing in future rate cases, or at least to use such pricing as the starting point to set rates in future rate cases.

Ramsey pricing provides a superior "second best" methodology for setting rates. Of course, the best methodology is to use marginal costs to set rates. But in the case of a natural monopoly, this is not feasible because revenues generated by such rates would not recover costs without subsidies. If subsidies are not offered, another method has to be found that will set rates high enough to cover costs. Ramsey pricing is one method of doing so. Ramsey pricing is a superior "second best" methodology because the rates it leads to have "[t]he remarkable property ... that they minimize the resulting welfare losses" (OCA Witness Sherman, OCA-T-300 at 5).

Ramsey pricing has yet another advantage which stems from it being derived by a formula. It is that the Ramsey pricing makes objective that which is subjective and transparent that which is opaque. These advantages suggest Ramsey pricing is the preferred way to set rates for natural monopolies like the Postal Service. The Commission would not need to use the Ramsey pricing methodology in every instance. However, it should be a starting point from which rates are set, with justifications for any deviations. In this rate case, the USPS did not use Ramsey pricing and its proposed rates deviate from Ramsey rates. The OCA compared the proposed rates to those generated by Ramsey pricing. The comparison is in the testimony presented by OCA Witness Sherman (OCA-T-300) at Table 3. According to the table, when the Ramsey pricing was constrained to 1) Revenue Foregone Reform Act ("RFRA") rules; 2) revenues not being less than a sub-class's incremental costs; and 3) the markup not exceeding the first class markup by more than ten percent, then the rates that emerged in most but not all cases were close to the ones proposed by the Postal Service for R97-1. (Compare column 4 to column 5 of Table 3.) While proposed rates deviate from Ramsey rates, they do not deviate by all that much. Ramsey rates are preferable because they have a smaller welfare loss (OCA-T-300, at 27). Nonetheless, the APWU recommends that the Commission accept the USPS proposed rates because those rates are close to Ramsey rates.

While Ramsey pricing is a superior way of setting rates, it has its pitfalls. One kind of pitfall emerges when the data are incorrect. Section II outlines one instance of deficient data. Another instance can be found in Postal Service Witness Bernstein's testimony (USPST-31). He attempts to estimate the hypothetical first class presort discounts without the appropriate data. According to Witness Bernstein's response to APWU interrogatory APWU-T-31-1, he had "... no information regarding what might be the marginal cost of single-piece mail that shifts to workshare mail." In place of having actual information, he used "...the assumption that all single-piece mail has the same postal marginal cost and that all workshare mail has the same (lower) postal marginal cost." He made his assumption because it allowed him "... to calculate Ramsey prices for single-piece and workshare letters." The likelihood, though, is that this assumption is incorrect because the marginal cost of the mail that shifts from ordinary mail to discounted mail will be larger than the marginal cost of the discounted mail itself. Insofar as Witness Bernstein's marginal cost estimate is likely to be inaccurate, his estimation of the hypothetical discounts for discounted mail is likely to be inaccurate. Moreover, because his estimate errs on the side of being too small, his estimate of the discounts errs on the side of being too large.

Another area where the use of Ramsey pricing can be problematic is when close substitutes are involved. This could arise when discounts are offered for one type of mail that is a close substitute for another. With close substitutes there can be an inability to estimate Ramsey prices even when all the necessary information is available. OCA Witness Sherman in his testimony (OCA-T-300, Section D at 38 ff.) discussed such a problem with first class presort and first class non-presort, specifically in connection with first class letters and parcels. This problem arises when cross elasticities of demand are too high. Two possibilities for this emerge: Ramsey prices are unstable; or they cannot be determined because equilibrium cannot be achieved. *In either case*, Ramsey pricing *cannot* be used for determining rates. Witness Sherman presented compelling evidence that there is implicitly a high cross-elasticity between "discounted first class letters and parcels", and "ordinary single piece letters and parcels." (See OCA-T-300, at 45 ff.) By implication, Ramsey pricing based on Witness Bernstein's methodology could not have been used for determining the rates for discounted letters and parcels, and by extension, it could not have been used by the USPS to determine the discounts for that kind of mail.

Consequently, the Commission should continue to use the current methodology of cost avoided to determine discounts for presorted and barcoded first class letters and parcels. In this rate case, the cost avoided methodology indicates that the discounts proposed by the Postal Service are appropriate.

IV. THE COMMISSION SHOULD IMPLEMENT THE NEW PREPAID REPLY MAIL RATE CATEGORY REQUESTED BY THE USPS IN FIRST CLASS MAIL

The USPS requested a new category of first class mail -- prepaid reply mail. This rate category allows consumers to participate directly in the benefits of automation. Thus far only the large mailers enjoy the benefits of automation. Over the last several rate cases, there has been discussion about instituting such a rate category. This is the first time the Postal Service proposed doing so.

The APWU supports, as it has in the past, a prepaid reply mail category. The time has come for consumers to experience more directly the benefits of automation. Hence, the APWU supports the Postal Service's request to implement the new prepaid reply mail category which takes advantage of Postal Service automation and gives consumers the discount determined by the costs avoided.

Some may argue that it may be too expensive to provide prepaid reply mail to bill payers. The reasons that might be offered include the expense of providing an audit trail and the expense of providing replacement envelops. What is not said is that no one will be forced to offer consumers prepaid reply envelopes. If it is indeed too expensive to provide prepaid mail envelopes, then market forces will dictate against providing prepaid reply envelopes to consumers. On the other hand, if the opposite is true then consumers will receive prepaid reply envelopes in their bills. The Commission should not be a barrier to the implementation of the prepaid reply mail category. It should recommend that the USPS proceed with the prepaid reply mail rate category.

The Office of Consumer Advocate ("OCA") is critical of the prepaid reply mail category and instead proposes a Courtesy Envelope Mail ("CEM") category (OCA-T-400). The CEM requires the bill payer to affix a postage stamp on the reply envelope. While the OCA's proposal has some merit, it has a major disadvantage. It requires consumers to carry around two denominations of stamps, one for regular letters and one for CEM envelopes. As USPS Witness Fronk has stated the prepaid reply mail category "offers consumers the convenience of prepaid envelopes and cards, and it avoids burdening and confusing the public with differently-rated postage stamps for both letters and cards." (USPS-T-36 at 6) Because of the potential burden and confusion to the public, the Commission should not substitute the OCA's proposal for the prepaid reply mail category.

V. THE COMMISSION SHOULD ACCEPT THE CONCLUSION OF USPS WITNESS BRADLEY'S TESTIMONY THAT LABOR RELATED MAIL PROCESSING COSTS VARY BY LESS THAN VOLUME

In this rate case, the USPS presented testimony about the variability of mail processing labor hours as they relate to mail volume. (See USPS-T-14.) In earlier rate cases, the Postal Service assumed that labor hours, and therefore mail processing costs, vary directly with volume. USPS Witness Bradley presented testimony showing that labor hours do not vary directly with volume. For this rate case, the Postal Service used Witness Bradley's findings to set rates and discounts.

A number of intervenors presented testimony objecting to USPS Witness Bradley's methodology. The testimony of Witness Smith for the OCA is an example. (See OCA-T-600) He argues that the assumption used in earlier rate cases by the Postal Service, that labor hours vary directly with volume, is correct (see OCA-T-600, at 23 ff., esp. Diagram 1 at 25). Witness Smith and other intervenors argue that the Commission should use the assumption of earlier rate cases in this rate case. These intervenors have not satisfactorily addressed the following point: when labor is one of several inputs to process mail, why should labor be assumed to vary directly with volume? When labor is one of several inputs, economic theory dictates that labor should not vary directly with volume while other factors hold constant. Hence, economic theory would lead to a rejection of the assumption used in earlier rate cases.

While labor can be assumed not to vary directly with volume, what remains unanswered is whether labor varies by more or less than volume. For most firms the expectation is that labor varies by more than volume. What leads to this expectation is that most firms are characterized by diminishing returns. The USPS, though, is presumed to be an increasing returns to scale operation. Consequently, there is the possibility that labor varies by less than volume. Indeed, USPS Witness Bradley found that for a variety of Postal Service activities labor hours vary by less than volume.

Of course, it is possible to disagree with certain aspects of Witness Bradley's methodology, and in future rate cases refinements can be made. Nonetheless, the overall reliability of his findings indicates that the Commission should accept his methodology for this rate case. By extension it should accept the rates and discounts which have been determined from it.

VI. CONCLUSION

For the above foregoing reasons the Commission should accept the Postal Service's test year estimates and implement the requested rate increase; reject the arguments to increase rates even further in mail classes where business has been growing the fastest, in particular Standard B parcels; use Ramsey pricing as a starting point to set rates; implement the prepaid reply mail rate category requested by the USPS; and accept the conclusion of the USPS Witness Bradley's testimony that labor related mail processing costs vary by less than volume.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the rules of practice.

Date: April 1, 1998

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